Chapter 3
Islamic Financial Transactions

3.1 Islamic Law (Shari’ah)

The Islamic Law (Shari’ah) is the heart of Islamic religious concern. Islam is an eminently practical way of life and the Shari’ah is the guidance for all the specific situations, so that one may know how to achieve the pleasure of Allah (SWT) in this life and in the Hereafter. The prescriptions of the Shari’ah are ordained by God as His Eternal Will. It is thus, the standard of right and wrong in human affairs and provides an all-inclusive score of religious valuation for conduct. Every human deed falls under the perspective of the law, without exception.¹

The assumption underlying the Shari’ah is that men are incapable of discriminating right and wrong by their own un-aided powers. It was for this reason that guidance was sent to them through Prophets. God, who is All-powerful and the wisest, has decreed a pathway for mankind. His decrees are based upon nothing but His Sovereign Will; they are not subordinated to rational considerations, nor are they to be judged by the standard of reason. It follows, therefore, that the Shari ah is Taubahui (worship), to be obeyed as a slave obeys his master.²

The term “Islamic Law” is somewhat ambiguous in that it conflates two Arabic terms, Shari’ah (divine law) and Fiqh (human comprehension of that law). The distinction is an important one. In the first instance, since God is the true and only law-giver, any legal position must ultimately be rooted in the Quran and the Sunnah, which are understood to be

the revelation of His divine will. However, when it comes to the practical application of this divine law to individual situations and the circumstances of everyday life, the responsibility lies with those who are skilled in interpreting the revealed sources, namely qualified religious scholars or Ulama.3

3.2 Sources of Islamic Law (Shari'ah)

3.2.1 Primary Sources

The primary sources are the Quran and Sunnah. This is based on the fact that Islam urges its followers to refer to these sources in solving problems that occur in their daily lives as commanded by Allah.4

The Holy Quran

The word “Quran” means something recited or read; applied to the revelations made to the Prophet of Islam (PBUH); it may indicate that they are to be used for recitation in worship. The messages given to Muhammad (PBUH) by the Angel were taken from a heavenly Book, uncreated and eternally consistent with God that is called the Mother of the Books or the Well-preserved Tablet.5

The key text upon which the Shari'ah is founded is of course the Quran, that is to say, the Revelations of the Prophet Muhammad (PBUH), which came from God. As the Quran is “historically and ideologically the primary expression of Islamic law” therefore all Muslims are commanded to obey Allah (SWT) and Prophet (PBUH).6

Allah (SWT) said:

3 Khiyar Abdallah Khiyar, No.1, p.108.
“Oh you who believe Obey Allah (SWT) and obey the Messenger and those charged with authority among you if you differ in anything among you; refer it to Allah (SWT) Quran and His Messenger Sunnah.”

Surah al-Nisa: 59

Hence the absolute supremacy and the majesty of God are most strikingly emphasized by the Quran. The Prophet was, to all intents and purpose, sent primarily to exemplify the teachings of the Quran and present to the world a model of ideal practical life. Hence the first important source of Islamic Law is Quran. The Sunnah, by its very nature, therefore, never goes against the Quran, nor does the Quran go against the Sunnah.

The Prophetic Tradition (Sunnah)

The word “Sunnah” literally means “a beaten track” and thus an accepted course of conduct. In Islamic thought, it refers to all the acts and sayings of the Prophet (PBUH) as well as everything he approved. The later are described as Hadith which literally means a “Narrative” or “communication” but in this context is understood to refer specifically to an account of the life and conduct of the Prophet Muhammad (PBUH), who is regarded by all Muslims as their ideal role model. The Hadith were assembled from the recollections of the Companions of the Prophet (PBUH), and was only put down in writing after some considerable time had elapsed since Muhammad’s (PBUH) death.

The Sunnah, which consists of the sayings of and the actions done and/or approved by the Prophet (PBUH), is an equally important source of information in Islamic law. The importance of sticking to Sunnah is obvious from the following verse of the Holy Quran.

Allah (SWT) said:

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8 Angelo M. Venardos, No.3, pp.28-29.
“Indeed you have in the Messenger of Allah an excellent example for the one who hopes in Allah and looks to Last day” (33:21)

“So take what the Prophet (PBUH) assigns to you and deny yourselves that which he withholds from you” (Surah al-Hasyr: 7)

Therefore, Sunnah is the second important sources of Islamic law but ultimately the Quran takes priority over the Sunnah as a source of law; jurists should resort to the Sunnah for legal guidance only when no clear directive can be obtained from the Quran.10

3.2.2 Secondary Sources

Apart from the two primary sources the Quran and the Sunnah, the Islamic law also passed a resolution to use secondary sources and other Islamic Jurisprudence Manhaj are called “Ijtihad”. These methods are collectively described as Ijtihad which literally means effort, signifying the use of intellectual exertion by a jurist to derive an answer to a question. Ijtihad observes a particular methodology called “The roots of the law” (Usulat-figh) which include the following recognized methods of reaching a decision: Ijma, Qiyas, Istisna, Maslahah Mursalah, Istishab, Sadd Zariah, and Urf.11

- **Ijma**: Ijma has been defined as the “consensus of opinion of the Companions (Sahaba’h) of the Prophet (PBUH) and the agreement reached on the decisions taken by the learned Muftis or the Jurists on various Islamic matters”.12

- **Qiyas**: literally means making a comparison between two things with the view of evaluating one in the light of the other. In Shari’ah law it refers to the extension of a Shari’ah ruling from an original case to a new case, on the grounds that the latter has the same effective cause as the former.13

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10 Angelo M. Venardos, No.3, p.29.
11 Suruhanjaya Sekurity, No.4, p.9.
13 Angelo M. Venardos, No.3, p.34.
• **Istihsan**: The word means literally, to hold something for good, right. According to the treatises on “Usul-al-Fiqh,” Istihsan technically denotes the abandonment of the opinion to which reasoning by analogy (Qiyas) would lead, in favour of a different opinion supported by stronger evidence.\(^{14}\)

• **Maslahah Mursalalah**: Maslahah Mursalalah or public interest is very similar to Istihsan. If it is evident that a particular course of action will result in public benefit, it may be followed. This is one of the means by which the Shari’ah can be adapted to meet the need to accommodate social change.\(^{15}\)

• **Istishab**: when the existence of a thing has been once established by evidence, even though later some doubt should arise as to its continuance in existence, it is still considered to exist. It is called Istishab al- Hal, if the present is judged according to the past, and Istishab al-Madi, if the reverse is the case.\(^{16}\)

• **Sadd Zari’ah**: This refers to the approach used to curtail anything that can cause a Muslim to be forbidden. It is considered an early preventive measure to prevent a Muslim from doing what is forbidden by Allah (SWT).\(^{17}\)

• **Urf**: This refers to the norms of the majority of a society whether applied in speech or deed. It is considered as Adat Jama’iyah (customs that are collectively acceptable) and can be used as a legal basis so long as it does not contradict the Shari’ah.\(^{18}\) In the context of the Islamic capital market, “Urf Tijari” refers to customary practices in businesses that are considered a basis for guidance and Hukum.


\(^{15}\)Angelo M. Venardos, No.3, p.34.

\(^{16}\)Muhammad Abdul Mannan, No.7, p.37.


3.3 Five Degrees of Admissibility Ranging

Every aspect of Islamic society is subject to the lens of Shari'ah scrutiny and can be classified according to five degrees of admissibility ranging from the obligatory to the absolutely forbidden. They are as follows:

- Obligatory (Fard or Wajib) – An obligatory duty, the omission of which is punishable.
- Desirable (Mandab or Mustahab) – An action which is rewarded, but the omission of which is not punishable.
- Indifferent (Jaiz or Mubah) – An action which is permitted and to which the law is indifferent.
- Undesirable (Mukruh) - Which is disapproved of, but which is not a punishable offence, though its omission is rewarded.
- Forbidden (Haram) – An action which is absolutely forbidden and punishable.

Together, these categories define the universe of what is and what is not possible in Islamic society and they apply just as much to financial transactions as to any other kind of activity.\(^\text{19}\)

3.4 Objectives of Islamic Law (Maqasid Al-Shari'ah)

This intense commitment of Islam to brotherhood and justice makes the well-being (Falah) of all human beings the principal goal of Islam. This well-being includes physical satisfaction because mental peace and happiness can be achieved only by means of a balanced realization of both the material and spiritual needs of the human personality. It must be accompanied by ensuring efforts directed to spiritual health at the inner core of human consciousness, and justice and fair play at all levels of human interaction. Only

\(^{19}\text{Angelo M. Venardos, No. 3, p. 28.}\)
development of this kind would be in conformity with the Maqasid al-Shari'ah or objective of the Shari'ah (referred to hereafter as the Maqasid of the goals.)

By the time of Al-Ghazali, the principle of Islamic Jurisprudence (Usul al-Fiqh) was well established as a separate discipline. A discussion on the objectives of Islamic Law (Maqasid al-shari’ah) belonged to this subject of study. Endorsing the generally accepted view that Shari’ah sought to promote the welfare (Masalih) of human beings, Ghazali noted that the objectives of Shari’ah that relate to people are five: that is to protect their religion, life, reason, progeny and property, so whatever serves these five basics is Maslaha.

Shatibi discussed the subject in detail, giving Maslaha a central place. He endorsed the list of five objectives given earlier by Ghazali, but did not give it much importance. More significantly, he had a perception that wealth (Mal), last in Ghazali’s list could be a means to the realization of the other objectives mentioned in that list. He paid great attention to three levels of realization for every objective of Shari’ah or Maslaha: absolutely necessary (Daruriyyah), requirements (Hajjiiyyah) and beautification (Tahsiniyyah).

Absolutely Necessary (Daruriyyah)

These are the objectives which are basic for the establishment of welfare in this world and the world hereafter in the sense that if they are ignored, then the coherence and the order cannot be established. Daruriyyah relate to five things: Protection of faith (din); Protection of life (Nafs); Protection of posterity (Nasil); Protection of property (Mal); Protection of intellect (Aql).

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Requirements (Hajiyyah)

Shari'ah aims at facilitating life or removing hardship. All such provisions of Shari'ah which aims at facilitating life, removing hardship, etc., are said to fulfill the Hajiyyah of halal goods for food, lodging and conveyance, etc., since such permission would facilitate life or remove hardships.

Beautification (Tahsiniyah)

Shari'ah beautifies life and puts comforts into it. There are several provisions of Shari'ah which are meant to ensure better utilization, beautification and simplification of Daruriyyah and Hajiyyah, for example, permission to use beautiful and comfortable things; to eat delicious food; to wear fine clothing and so on.22

3.5 The Major Schools of Islamic Law (Mazhab)

At this stage it should be clearly understood that the interpretation and application of both revealed and non-revealed knowledge have given rise to the emergence of different Fiqh schools. The differences between schools relate to all the various subjects of human interest on which the Shari'ah has had something to say. The most important of the Fiqh schools can be classified to Four Major Fiqh Schools.23

1. Hanafi

The Hanafi school of thought was established by Imam Abu Hanifah (80-150 AH) and his famous student, Abu Yusuf and Muhammad. They emphasized the use of reason rather than blind reliance on the Sunnah. This school is mostly prevailing in India and the Middle East.

22 Khiyar Abdallah Khiyar, No.1, pp.116 -118.
23 Muhammad Abdul Mannan, No.7, p.37.
2. Maliki

The Maliki School adheres to the teachings of Imam Malik (96-178AH) who laid emphasis on the practices of the people of Medina as being the most authentic examples of Islamic practice. The moors who ruled Spain were the followers of the Maliki School, which, today, is found mostly in Africa.

3. Hanbali

The Hanbali School was founded by Imam Ahmad Ibn Hanbal (163-240AH) who had a high reputation as traditionalist and theologian, and adopted a strict view of the law. The Hanbali School today is predominant in Saudi Arabia.

4. Shafi’i

The Shafi’i School was founded by Imam As-Shafi’i (149-204AH) who was a student of Imam Malik, and is thought by some to be the most distinguished of all jurists, he was famed for his modernization and balanced judgment, and although he respected the traditions, he examined them more critically than Imam Malik did. Followers of the Shafi’i School today are found predominantly in South-east Asia and as the focus of this book is on Islamic Jurisprudence in that region, it is the Shafi’i school that primary concerns us here.

Each of the schools is considered to be a full “Mujtahid” and is supposed to have its own system of theory and application of laws. They have all been regarded as “orthodox” and they have considered one another as such. However, the diversity of views as presented by the different Fiqh schools provide us with a system of built-in flexibility in interpretation and application of Fiqh, which is the body of legal prescriptions concerning human affairs derived from the Shari’ah a generic name given to the complete collection of religious truths taught by the Prophet (PBUH).

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24 Angelo M. Venardos, No.3, pp.31-32.
25 Muhammad Abdul Mannan, No.7, p.38.
3.6 Interest (Riba)

Shari'ah ordains that a creditor's demand for any increase on capital over or above the principle in lieu of time, as a condition for extending credit, is Riba or interest, and strictly prohibited. The prohibition of interest is absolute; it does not matter whether the stipulated increase on capital is high or low, simple or compound, taken for personal or private, productive or consumption purpose. The rulings on the prohibition of interest are mentioned in holy Quran and also well-proven from the Prophet Mohammad (PBUH)'s traditions.

The Holy Quran has warned the swallower of interest with such a force and rigour that it is not to be found in the case of other sins and faults. The words of the Holy Quran in this connection are characteristic: For instance:

"O ye who believe! Observe your duty to Allah and give up what remain (due to you) from interest if you are (in truth) believers. And if ye do not, then be warned of war (against you) from Allah and His messenger. And if ye repent, then (let there be) postponement to (the time of) ease; and that ye remit the debt as alms giving would be better for you if ye did but know." Quran II. 2, 8-280

Beside the Holy Quran, a number of reliable Traditions also exhibit strong prohibitive orders against interest. For instance:

(It has came down) from Jabir, may God the Almighty be pleased with him, who said: The Messenger of Allah, on whom be peace, cursed the devourer of interest as also its giver, the scribe of the deed and witnesses to it, and said: they are alike (in the degree of sin). (Muslim)

3.6.1 Definition of Interest (Riba)

After knowing this severe verdict of the Qur'an and the Sunnah against Riba, it is necessary to determine what it really stands for. The three-letter past-tense root of the term is

Arabic verb “raba”, literally means increase, addition, expansion or growth. Shari‘ah scholars have used the term Riba in three senses; one basic and two subsidiary. In its basic meaning Riba can be defined as “anything (big or small), pecuniary or non-pecuniary, in excess of the principal in a loan that must be paid by the borrower to the lender along with the principal as condition, (stipulate or by custom), of the loan or for an extension its maturity. This is called Riba al-Qardh or Riba al-Nasa. It is also referred to as Riba al-Quran as this is the kind of Riba which is clearly mentioned in the Quran and is known today as “Interest of loans”

However, the term Riba has a more comprehensive implication and is not merely restricted to loans. Even though Islam has allowed the sale of goods and services, Riba may surreptitiously even enter into sale transaction. Hence the two subsidiary meanings of Riba relate to such transaction and fall into the category of Riba al-byyu (riba on sale). The first of these is Riba al-Nasi‘ah, which stands for the increase in lieu of delay or postponement of payment. The second is Riba al-fadl, which relates to the purchase and sale of commodities.

As mentioned in the definition of Riba given above is Riba. Such additional payment in modern terminology is known as interest. Thus Riba and interest are the same. The equivalence of Riba to interest has always been unanimously recognized in Muslim history by all schools of thought, this without any exception.

3.6.2 Interest and Usury

Calling usury or Riba by the name of “interest” will not change its character since interest is nothing but an addition to the borrowed capital, which is usury in both spirit and in

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the Islamic code of law. Thus Interest and Riba are same in Islamic law, but in modern economic terminology, the interest and usury are not synonym;

Interest: “Interest is a fee paid by a borrower of assets to the owner as a form of compensation for the use of the assets. It is most commonly the price paid for the use of borrowed money, or money earned by deposited funds.”

Usury: “Practice of lending money at exorbitant interest especially at higher interest than is allowed by law.”

Thus, in Islam, as an excess over the principal is Riba, it covers usury and interest both. Therefore, it cannot be contended that Riba applies to usury or lending of money at an exorbitant rate which is cruel, while interest at a low rate is allowed, nor can there be any distinction between the interest for productive purpose and the interest for non-productive purposes.

3.6.3 Types of Interest (Riba)

There are two types of Riba: Riba al-fadl and Riba al-Nasi’ah

1. Riba al-Fadl: is affected by an increase of traded set of goods over its compensation without any deferment. This type of Riba comes into effect only if the two compensations are of the same genus (Ribawi product) in different quantities.

2. Riba al-Nasi’ah: Where one of the two compensations is increased because of deferment, with no other form of compensation for that increased. This type of Riba comes into effect regardless of whether the traded goods are of the same or of different genera, and whether they are traded in equal or different amounts.

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31 Oxford Dictionaries
3.6.4 Division of Interest (Riba)

In general, Riba is divided into two categories:

1. Riba Qurudh is Riba that occurs through debt/loan.
2. Riba Buyu is Riba that occurs through trade.

Riba Qurudh Concept:

Riba as practiced by the Arab Jahiliyah came in a few forms. When the verse of prohibition of Riba was introduced, the practice of Riba was still being carried out. Riba Qurudh involves lending money and imposing interest. Among the forms of Riba practiced are as follows:

a) The debtor borrows a certain sum for a certain period according to the agreed terms; the debtor must pay back more than the capital sum or loan;

b) A creditor gives a periodic loan and earns monthly interest. The land/capital sum lasts until the period of expiry. Upon expiry, if the debtor fails to pay back the capital sum, the period to pay back will be extended. The creditor will continue collecting interest until the new expiry date.

c) A trader sells his product with payment deferred to a specific period. If the buyer fails to pay within that period, the period will be extended by increasing the interest on the product price.

Riba Buyu Concept:

Riba Buyu occurs in the trading of Ribawi products as stated by the Prophet (Saw) in Hadith:

“Exchange gold for gold, silver for silver, grain for grain, barley for barley, dates for dates, salt for salt in the same amount and of the same type and must be handed over in an aqiq ceremony. If what you have exchanged differ in type, you can trade according to you wishes but it must be done on the spot.”

(Muslim)
It covers two types of Riba: Riba Nasi'ah, trading in which the settlement is deferred and not done on the spot and Riba fadil which means unlawful excess gained in any exchange of Rabi'awi product. Based on the Hadith above, Islamic jurist have set down specific conditions for trading Rabi'awi products with similar Ilalah (reason) and type. Exchange must be of the same weight or measure; and settle on the spot and handed over in an Aqad ceremony.  

3.6.5 Reasons of Prohibition

The Islamic rationale for the prohibition of Interest (Riba) is the exploitative nature of interest. Interest-based transactions violate human’s birthright — free will. Interest-based consumption loans are taken out by the poor in times of hardship. Charging interest on such loans is sheer exploitation of the poor, which further aggravates social and economic disparities in the policy. Commercially based lending holds the borrower solely responsible for bearing all risks and losses and repaying the principal and accruing interest to the lender.  

Interest also has many adverse consequences for the economy. It results in inefficient allocation of society’s resources, and contributes to the instability of the system. In an interest-based system the major criteria for the distribution of credit is the credit-worthiness of the borrower. In a sharing system the productivity of the project is more important. Therefore, the finances go to more productive projects. In this way, instead of resources going to low-return projects for borrowers with better credit-worthiness, bank lending is more likely to flow to high-return projects even if the credibility of the borrower is somewhat lower.  

Why does Allah permit trade and forbid interest? What is the difference between the two? The difference is that profits are the result of initiative, enterprise and efficiency. They

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36 Suruhanjaya Sekurity, No.4, pp.97-98.
35 M. Mansoor Khan and M. Ikhla Bhatti, No 26, p.21.
result after a definite value-creating process. Not so with interest. In the case of interest you know your return and can be sure of it. In the case of profit you have to work to ensure it.  

The final reason is that the Holy Quran which is the highest authority on Islamic Law lays down clear and unambiguous orders against all Riba transactions. It is not necessary, therefore, that reasons must be advanced for order enjoined in it.  

3.7 Uncertainty (Gharar)

Another strictly prohibited condition of sales transactions is Gharar, or deception. In fact, calling a transaction Riba-free implies that it is also Gharar-free. The word is derived from the Arabic root word Ghoroor, meaning arrogance and deception.

A good translation of Gharar is "risk" or "uncertainty". Another definition that is more attuned to modern economics was given by the late Professor Mustafa Al-Zarqaa. He defined the forbidden Gharar sale as "the sale of probable items whose existence or characteristics are not certain, the risky nature of which makes the transaction akin to gambling."

3.7.1 The Prohibition of Uncertainty (Gharar)

The Quran lays the foundations for fair business dealings, stipulating that contracts must fully disclose all aspects and specifications of the items involved in the transaction:

6:159 . . . "give measure and weight with (full) justice; —no burden do We place on any soul, but that which it can bear; —whenever ye speak, speak justly, even if a near relative is concerned; and fulfill the covenant of God. Thus doth He command you that ye may remember"

There are numerous Hadith forbidding Gharar Sale and specific instance thereof for instances:

"The Prophet (PBUH) has forbidden the purchase of the unborn animal in its mother's womb, the sale of the milk in the udder without measurement,

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38 Anwar Iqbal Qureshi, No.27, pp.53-54.
the purchase of spoils of war prior to their distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver.”

All such cases involve the sale of an item which may or may not exist. In such circumstances, to mention but a few, the fish in the sea may never be caught, the calf may be still-born, and the fruits may never ripen. In all such cases, it is in the best interest of the trading parties to be very specific about what is being sold and for what price.40

3.7.2 Kinds of Gharar

In fact there are only two ingredients of the contract; subject matter and price. A state of contract comprising upon an uncertainty with regard to both of the two or anyone of them will be considered as Gharar. If we consider upon a sale-contract we can realize that the contract can consist upon six types of Gharar.

1. Uncertainty relating to the existence of thing-sold.
2. Uncertainty relating to the possession of thing-sold.
3. Uncertainty relating to the thing-sold itself.
4. Uncertainty relating to the price itself.
5. Uncertainty relating to the payment of price.
6. Uncertainty relating to both thing-sold and price.

It appears by a thorough examination of all these six categories that Gharar is available in the last four kinds, either in both things-sold and price or in one of them, as all of them consisted upon Jihalat (ignorance).41

3.7.3 Form of Gharar Transactions

Siddiq al-Darir an eminent modern scholar of Shari’ah has given a detailed list of transactions that involve element of Gharar. Gharar, in his view, sometime relate to the form of contract and sometimes to its subject matter.

41Maulana Eijaz Ahmad Samadani, Islamic Banking and Uncertainty (Karachi: Darul Ishaat, 2007), pp.15-16.
I- Gharar or Uncertainty Relating to Sighah (Form) of Contract:

The transactions belonging to this category are as follows:

1. **Two Sales in one**: Two sales in one means that a single contract relates to two sales, such as say a buyer “I sale you this commodity 400 rupees on cash and hundred and fifty on credit” without indeterminacy of the price. Thus the seller does know at which price the buyer will buy the object.

2. **Earnest money (Aurbun) Sale**: It is a sale in which a person buys an item and pays a certain amount of money in advance to the seller on condition that if the transaction is completed the advance will be adjusted and if the bargain is cancelled the seller will not return the advance.

3. **Contingent Sale**: it is contract that is contingent upon a condition e.g. “I sold you my house if A sold his house to me”. The Gharar at work behind this contract is that it is contingent upon the happening of an uncertain future event.

4. **Contract effective from future date**: It is a contract, which comes into effect at some future date.

II- Gharar and Uncertainty Relating to Subject-Matter:

This is of the following eight types:

1. **Uncertainty regarding the genus of the object**: It is where a person says to another. “I sell you an item for ten”, and does not specify the object to sale.

2. **Uncertainty regarding the kind of the object**: The seller tells the buyer: “I sell you an animal at such and such price”, without indicating the kind of animal.

3. **Uncertainty regarding attributes of object**: It is where the necessary attributes of the object of the sale are not described.

4. **Uncertainty regarding the quantity of the object**: The knowledge of the quantity of object is necessary for validity of sale.
5. **Uncertainty regarding specification of object**: Such as in the sale of piece of cloth out of bulk without specifying one of them in particular.

6. **Uncertainty regarding the time of performance**: If the sale is on credit i.e. on deferred payment basis, the time of payment should be made known to the seller.

7. **Uncertainty regarding the existence of object**: This is another form of Gharar, which relates to non-existent commodity such as sale of what this animal will produce.

**Uncertainty regarding delivery of object**: Inability of seller to deliver the object of sale to the buyer also forms Gharar, which invalidates the contract.\(^{42}\)

### 3.8 The Contract (Aqd)

"Aqd" is synonymous with the word "contract" found in modern law. It is of common occurrence in Islamic legal literature. It implies obligation arising out of mutual agreement. The literal meaning of the word Aqd is "to join" and "to tie". The term Aqd has an underlying idea of conjunction as it joins the intentions and declaration of two parties.

#### 3.8.1 Definition of (Contract) Aqd

In Islamic legal literature Aqd is used in two senses i.e. general and specific. In the general sense Aqd is applied to an obligation irrespective of the fact that the source of this obligation is a unilateral declaration or agreement of two declarations. In the specific sense it has been defined in different ways. However, the common feature of all definition is that it is a combination of an offer and acceptance which gives rise to certain legal consequence. Some important definitions of "Aqd" in the modern senses of bilateral obligations;\(^{43}\)

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“It is where the two parties undertake obligations in respect of any matter. It is affected by the combination of an offer (Ijab) and acceptance (Qabul)”.

3.8.2 Elements of Contract (Aqd)

A contract comprises the following elements:

a. The existence of two parties who must be capable of entering into contracts, i.e. they must be mature and sane.

b. An offer (Ijab) and acceptance (Qabul).

c. A legal (Shari’ah) basis of union between the two declarations.

d. The contractual obligations.

e. And free from all prohibited factor.

The essential elements of a contract are threefold and if these elements are not found properly, the contract is invalid:

- The form, i.e. offer and acceptance (Sighah);
- The subject matter (Ma’qudalayh);
- The contracting parties (Aqidain).

Offer (Ijab) and Acceptance (Qabul): Form of the Contract

Ijab has been defined as “a declaration that is made first with a view to creating an obligation, while the subsequent declaration is termed qabul.” Offer and acceptance can be conveyed by spoken words, in writing or through indication and conduct. Condition necessary for Sighah (form), as stated earlier, the Sighah (form) comprises an offer (Ijab) from one party and an acceptance (qabul) from the other. Muslim jurists, however, have laid down certain condition for offer and acceptance without the fulfillment of which the contract cannot be concluded. These conditions are:

a) Conformity of the offer and acceptance on the same subject matter; and

45 Muhammad Ayub, No.9, p.106.
b) Issuance of the offer and acceptance in the same session (Majlis)  

The Subject Matter (Ma’qudAlayh)

The subject matter of a contract may include the object of the contracts, a commodity of performance of an act. Detailed conditions in respect of subject matter in various types of contracts are different, but on the whole; the subject matter should be existing/existable, valuable, usable, capable of ownership/title, capable of delivery/possession. Specified and quantified and the seller must have its title and risk. If a nonexistent thing is sold, even with mutual consent, the sale is void according to the Shari’ah. The commodity, service or performance must not include things prohibited by the Shari’ah like wine, pork and intoxicants. It must be ritually and legally clean and permissible. Legality of the subject matter requires that the commodities should be owned by someone. It also requires that it should be free from legal charges. Thus, an asset mortgaged with a creditor cannot be sold until redemption of the asset upon payment of the debt. The subject matter should fulfill the objective of the contract. Thus, public roads and parks cannot be the subject of a sale contract because these are meant for the benefit of the public and not for individuals. The subject matter should not be harmful to the contracting parties or the public in general. As such producing and trading in intoxicants like heroin, etc. is not a valid subject for contracts.

The Contracting Parties (Aqidain)

A basic requirement for conclusion of a valid contract is the necessity that the contracting parties should be qualified to enter a contract. Thus, such parties are required to possess legal capacity (Ahliyyat) for this purpose. The requirement for Ahliyyat-al-ada is

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46 Muhammad Tahir Mansuri, No.43, pp.25-33.  
reason and discretion. The method to check whether a person possesses faculties of reasons and discretion the lawgiver has associated such powers with puberty.

**Complete Capacity**

Complete capacity is established for a human being when he attains full mental development and acquires the ability to discriminate. Thus, the requirement of this capacity is reason (Aql) and discretion (Rusd). This standard is puberty. The sign of puberty is ejaculation in a male, and menstruation in a female. In the absence of these signs puberty is presumed to have occurred by the age of 15 in both male and female according to the majority of the jurist and at 18 years for male and 17 years for a female according to Imam Abu Hanifah.\(^\text{48}\)

### 3.8.3 Circumstances which Affect the Legal Capacity of a Person

1. **Junun (Insanity):** “Junun is the mental derangement which, except in rare cases, prevents a person from and dispositions utterances.”\(^\text{49}\)

2. **Atah (lunacy or partial insanity)** is partial or temporary insane person who acts sometime like a sane person and some other times like an insane person.

3. **Forgetfulness:** Forgetfulness is defined as: “A circumstance that befalls a man without his volition causing loss of remember of sometime.”\(^\text{50}\)

4. **Safah (Prodigally and Weakness of Intellect):** “Safah is that weakness of intellect which urges a person to act with respect to his property contrary to the dictates of intellect with the non-existence of mental disorder.”\(^\text{51}\)

5. **Death-illness (Marad al-Mawt):** “Death-illness is that form of illness from which death is to be apprehended in most cases, and illness which disables the patient from looking after affairs outside his house if he is a male, and the affairs within her home

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\(^{48}\) Muhammad Tahir Mansuri, No. 43, pp. 47-49.


if she is female, provided the patient dies in such condition before a year has passed.\textsuperscript{52}

6. **Intoxication**: intoxication is a condition, which overtakes a man on account of taking an intoxicant, and along with it his intelligence remains suspended, being neither lost nor diminished.\textsuperscript{53}

7. **Taflis (Bankruptcy)**: A person is considered bankrupt when his debts exceed his assets, and court on the demand of his creditors passes a prohibitory order restraining all alienation by him, and directs the sale of his property for the benefit of his creditors.

8. **Coercion**: coercion is to compel a person without having such a right, to do a thing without his consent or through fear. It is also defined as an action directed against a person, who suppresses his true consent.\textsuperscript{54}

These are certain factors, which impair legal capacity of a person and prevent him from concluding contracts and making disposition in his property.

### 3.8.4 Types of Contract

The Muslim Jurists classify contracts into Sahih (Valid), Batil (Void), and Fasid (voidable or irregular) contracts with regard to their legal validity.

**Valid or Sahih Contract**

The Sahih contract is said to be concluded when all its element are found, the conditions of each element have been met and it also possesses such attributes of extrinsic nature which the law takes notice of.\textsuperscript{55}

\textsuperscript{52} Ahmad Hassan, *Principles of Islamic Jurisprudence* (Islamabad: Islam Research Institute, 1993), p.323.

\textsuperscript{53} Hasan, No.50, p.204.

\textsuperscript{54} Muhammad Tahir Mansuri, No.43, p.59.

Irregular or Fasid Contract

The Fasid (irregular) contract is that whose elements are present (offer and acceptance) and all the essential conditions are complete, but an external attribute attached to the contract has been prohibited by the Lawgiver. The contract is legal as regards its *asl* but it is proper as the *wasf* is prohibited.56

Void or Batil Contract

Contracts that do not fulfill the conditions relating to offer and acceptance, subject matter, consideration and possession or delivery, or involve some illegal external attributes are considered void (*Batil*). In other words, if major conditions relating to the form of the contract (acceptance does not conform to the offer, or the offer does not exist at the time of acceptance, etc.), parties to the contract (sane and mature), possession and deliverability of the subject matter are not fulfilled, the contract is *Batil*.57

3.8.5 Classification of Contracts

The modern Muslim jurists have classified contracts from various perspectives to facilitate understanding. One classification is according to their function and purpose and the other is according to their time of completion.

Classification according to function of contract:

1. Acquiring of Ownership (Al-Tamlikat)

This relate to the acquiring of ownership of properties or the rights to the benefits of properties. The contracts in this group are further sub-divided into two sub-groups, namely:

a) Contracts of Exchange (Uqud al Muawadhat)

In contracts of exchange ownership is acquired by exchange such as sale, hire, money changing, compromise, partition, sale by other and the like. In such contracts there is an exchange between the two parties.

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57 Muhammad Tahir Mansuri, No.43, pp.87-89.
b) Contract of Charity (Uqud al-Tabarruat)

In contract of charity, a property is acquired without an exchange such as gift, alms, endowment, benevolent loan (Al-Qard al-Hasan) and assignment of debt.\(^{58}\)

2. Isqatat (Contracts Extinguishing Right):

The object of such acts and contracts is to extinguish established rights. They may be with consideration and without consideration. The example of first kind are divorce without consideration, manumission, remission of debt, withdrawal of the right of shufa’ah (pre-emption), whereas the divorce for consideration and accepting blood money instead of qisas are the examples of second kind.\(^{59}\)

3. Al-Itlaqat (Permission)

This kind of contract includes giving total responsibility to individuals, firms or agencies in the appointment of governors and judges; giving a person who is dispossessed of the power of administration, permission to administer his property, or giving permission to a minor to carry on trade; and the appointment of a nominee to take care of one’s children after death.\(^{60}\)

4. Al-Taqvidat (Contracts Restrictive Of The Rights of Others)

The principle feature of these contracts is to restrict the liberty of a person and prevent him from the right of disposal and use of property such as preventing insane, lunatic, minor, and insolvent person from dispositions.\(^{61}\)

5. Al-Tauthiqat (Security)

These contracts are meant to secure debts for their owners and guarantee creditors of debts owing to them. These are guarantee, assignment of debt and mortgage.\(^{62}\)

\(^{58}\) Khiyar Abdallah Khiyar, No.1, p.179.

\(^{59}\) Muhammad Tahir Mansuri, No.43, p.175.

\(^{60}\) Angelo M. Venardos, No.3, p.55.

\(^{61}\) Muhammad Tahir Mansuri, No.43, p.176.

6. Al-Ishtirak (Partnerships)
These contracts relate to sharing in projects and profits. They included al-Mudarabah, where a person gives an amount of money to another to trade or invest with the condition that they share in profit while the loss is borne by owner of the capital. They also included partnerships involving the cultivation of land and taking care of trees.

7. Al-Hifz (Safe Custody)
Contracts in this group relate to keeping property safe for its owner and include some of the functions of agency.\(^{63}\)

B- Classification of Contracts with Regard to Time of Completion:
Having regard to time of completion, the Muslim jurists have divided contracts into the following three kinds.

1. Al-Aqd al-Munjaz (Contract Immediately Enforceable)
It is a contract, which unconditionally becomes complete after the offer is accepted and its consequence in the form of obligation ensue immediately.\(^{64}\)

2. Al Aqd al-Mudafli al-Mustaqbal. (Contract Effective From Future Date)
Such contract is not valid according to majority of the jurists since they hold that the effects should ensue immediately without any delay.\(^{65}\)

3. Al- Aqd al-Mu allaq (Contingent Contract)
It is a contract, which is contingent upon happening of an uncertain event. Such contract takes effect on the happening of contingency. According to the majority the contingent contract are void especially when they belong to the class of commutative contracts such as sale and leasing.\(^{66}\)

\(^{63}\)Angelo M. Venardos, No.3, pp.55-56.
\(^{66}\)Muhammad Tahir Mansuri, No.43, p.182.
3.9 Specific Contracts

3.9.1 Contract of Sale

The contract of sale is one of the most important contracts for the exchange of goods. It is defined as “an exchange of a useful and desirable thing for similar thing by mutual consent in a specific manner.” Some jurists have added the words “for the alienation of property.” Thus the complete definition of sale will be as follows: “Exchange of useful and desirable thing for a similar thing by mutual consent for the alienation of property with mutual consent”.

Definition of Mal (Subject-Matter)

According to the Hanafi School, mal is that which is desired by the people and stored for use at time of need. It does not treat benefits and incorporeal rights as mal. The Shafi’i jurists, on the other hand, include benefits in the definition of mal. To them, the sale contract contains both transfer of ownership in goods and transfer of ownership in benefits.

Classification of Mal

Property has been classified in different ways:

1. Movable and Immovable
2. Fungible or Similar (Mithli) and non-Fungible or Dissimilar (Qimi)
3. Determinate (Ayn) and Indeterminate (Dayn) property

Conditions for Validity of Sale

1. Contracting parties should possess legal capacity necessary for concluding contract, i.e., they should be competent to conclude the contract.

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67 Kasani, Bada i al-Sana i, vol. 5, p. 133; Ibn al-HumamFath al-Qadir vol.5, p.73.
68 IbnAbiden, Radd al-Muhtor vol.4, p.3.
69 Shirbini, Mughni al-Muhtaj vol.2, p.3.
2. The commodity should be anything in which transactions are permissible in the Shari'ah. This means that it should be a pure substance ritually and legally clean.
3. The merchandise must be either in actual existence or it should be capable of being acquired and delivered to a buyer in the future.
4. The transactions, which involve an element of uncertainty and risk with regard to the existence and acquisition of subject matter, are forbidden in Islamic Law.
5. Goods should be owned by someone. If one sells something before acquiring ownership, such sale is invalid. The pious endowment (waqf) or public properties are also excluded from being the subject matter or sale contract.
6. The item should be possessed by the owner. It is a necessary condition so that he is able to deliver it to the purchaser in the event of the sale contract.
7. The item of sale should be known to the contracting parties. This requires that their subject-matter should be ascertained.
8. Consideration may be deferred to a fixed future period but it cannot be suspended on an event the time of the occurrence of which is uncertain.
9. The sale contract should be absolute and not contingent upon a future event.
10. The sale must be instant. The majority of the jurists are of view that sale contract must come into effect immediately on the conclusion of the contract. Its effects cannot be postponed to a future date.

Kinds of Sale Transactions

Following are important kinds of sale in Islamic Law.

1. **Muqayadah**: the sale of goods for goods, or barter trade.
2. **Bay Mutlaq**: the sale of goods for money.
3. **Sarf**: the sale of money for money or money changing.
4. **Salam**: this is a sale in which the price is paid in advance and the articles are delivered on a future date.

5. **Istisna**: A Contract of Manufacturing.

6. **Murabahah**: In such a transaction the vendor sells an article for the cost price in addition to a certain stated profit.

7. **Bay a-Muajjal**: Credit sale or sale on deferred payment basis.\(^{70}\)

### 3.9.2 The Loan Contract

Loans are generally similar to sales, since they involve the exchange of properties.\(^{71}\) Some of the jurists argued that loans are a subcategory of sales. However, Al-Qarafi listed three differences between loans and sales. Three legal violations are tolerated in loans but not in sales:

1. Loans may be made with goods eligible for Riba. This violates the rules of Riba.
2. For goods not eligible for Riba, loans may be concluded where a known is traded in exchange for an unknown, which is violation of the rule of Muzabahah.
3. For fungible goods, loans may involve selling which is not in the seller’s possession, which is not permitted in sales.

Those three rules are observed in sales but relaxed in loans. The reason for this relaxation of the rules for loans is to facilitate charitable behavior. In this regard, loans are permitted as a form of charity, where the lender gives up the usage of the goods for the period of the loan. This is also why loans are forbidden if they do not serve such a charitable cause, e.g. if the lender gets some benefit out of extending the loans.\(^{72}\)

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\(^{70}\) Muhammad Tahir Mansuri, No. 43, pp. 188-195.

\(^{71}\) Al-kasani (Hanafi), *Badai Al-Sanai*, vol. 7, p. 215.

\(^{72}\) Al-Qarafi (Maliki), *Al-furq Matbaat Al-Babi Al-Halabi*, vol. 4, p. 2.
Defining Loans

The Arabic term for loans, “Qard”, literally means “cutting-off a portion”, signifying that the person extending the loan is giving the borrower part of his property. It is also called “Salaf”, meaning “advance”, to signify that the amount of the loans is extended at some point with the expectation of repayment at the later time.

Legality of Loans

Loans are permissible based on Sunnah, as well as consensus of the Muslim Community. In this regard, it was narrated on the authority of Ibn Masud that the Prophet (PBUH) said: Every two loans extended by a Muslims to another count as one charitable payment”. Thus, loans are this highly recommended (Mandab) for the lender, and permissible for the borrower, based on the above listed Hadith.

Contract Parties and Language

The lender must have the right to deal in the property (e.g. through sales). This follows since it involves transferring property from one human to another, thus requiring an offer and acceptance in analogy to the cases of sale and gift contracts. The verbs used in the offer and acceptance may involve the terms “Qard” or “Salaf” (loans or advance) or anything that carries the meaning.

Objects Eligible for Lending

The Malikis, Shafiis, and Hanabalis ruled that loans are permissible for all goods eligible for forward sale (Salam) for all properties that can be established as a liability on the borrower. This includes goods measured by volume and weight (e.g. gold, silver, and foodstuffs), or non-fungibles (e.g. animals, tradable goods, etc.)

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73 Ibn Qudamah, Al-Mughani, (Beirut: Dar Al-kutub Al-Ilmiyyah), vol.4 p.179.
Summary of Validity Conditions

1. Loans must be concluded through the appropriate language of offer and acceptance.

2. The lender and borrower both be of legal age and have the mental faculties that makes him eligible to give charity.

3. The Hanafi's require that the lent goods be fungible, while the majority of jurists permit lending of any goods that may be established as a liability on the borrower (including non-fungibles such as homes and animals, etc.)

4. That the lent amount is known (in terms of volume, weight, number, or size), so that repayment of its legal is possible.

3.9.3 The Leasing Contract

The word *Ijarah* literally means to give something on rent. In the language of law it means of some object to somebody in return for some rental against a specified period. The word *Ijarah* is used for two different situations. In the first place, it means to employ the services of a person on wages given to his as consideration for his hired services. The second type of Ijarah relates to the usufructs of asset and properties, and not to services of human being. Ijarah in this sense means to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him.

Feature of Ijarah

1. The purpose of Ijarah contract is alienation of usufruct unlike contract of sale, which aims at alienation of property.

2. The benefits to be derived should be known and specified.

3. The benefits, which are the subject matter of contract, should be permissible in the Shari'ah.

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74 Wahbah Al-Zuhayli, No.33, pp.370-375.
4. The rent or compensation should be specified and fixed.
5. The period of contract should also be specified in the contract.

Legitimacy of Ijarah

The legality of Ijarah is established by the Quran, the Sunnah and Ijma.

Quran

I. Allah says: “And if they suckle your (offspring) give them their recompense”.76
II. “Said one of the (damsels): “O my father: engage him on wages. Truly the best of men for thee to employ is the man who is strong and trusty”.77

Sunnah

I. Said the Holy Prophet (SAW). “Give wages of the person hired before his sweat dries up.78
II. “If someone hires a person, let him inform him about the wages he is to receive”.79

Ijma

All the companions of the Holy Prophet (SAW) unanimously held that Ijarah is a lawful contract. They themselves practiced all lawful forms of this contract.

Kind of Ijarah

There are two main kinds of Ijarah, namely Ijarah al-Ashya and Ijarah al-Ashkhas.
1. Ijarah al-Ashya refers to hiring of things such as houses, shops, lands, animals and beasts etc. this is also known as Ijarah al-ayn.
2. Ijarah al-Ashkhas refers to hiring of services, such as to hire a painter to paint a house. This kind is also called Ijarah al-dhimah.80

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76 Qur'an, 65:6.
77 Qur’an, 28:26.
78 San’ani, Muhammad Ibnisma’il, Subul al-Salam (Beirut: Dar al-Fikr, 1983), vol.3, p.81.
3.9.4 The Deposit Contract

The term “Deposit” is used to describe both the deposited object, as well as the contract of depositing an object with another, i.e. giving the object to another for safe custody. Shafi’is and Malik’is defined the contract giving another person an agency (Tawkil) for safekeeping one’s property or legal possession.  

Legality

The deposit contract is permissible, and recommended, with proofs based on Quran, Hadith, and consensus:

**Quran:** “Allah commands you to return trusts to those to whom they are due”[4:58], and “And if one deposit a thing or trust with another, let the trustee discharge his trust” [2:283].

**Hadith:** Prophet (SAW) said: ‘Return trusts to the one who entrusted you, but do not betray the one who betrayed you”.  

**Consensus:** Jurists throughout the Islamic history have agreed that the deposit contract is permissible, based on the need (nay, necessity) of asking other to hold one’s property for safekeeping.

Deposit Cornerstones and Conditions

The majority of jurists enumerated four cornerstones:

(i) Depositor and Depositary.

(ii) Deposited Object.

(iv) Contract language (offer and acceptance).

81 Al-khatib Alshirbani (Shafiis), *Hashiyat Al-bijirmialasharh al-Iqna* (Egypt: Matba at Al-babi Al-Halabi), vol3, p.79.
82 Shawkani, No.79, p.297.
83 IbnQudamah, No.73, vol.6, p.382.
The depositor and depositary must be sane and discerning, thus restricting the insane and young children from making or receiving deposits. The object of deposit must be a form of property that can be possessed physically. Thus, deposits of runaway animals or birds in the sky are not guaranteed by the depositary. 85

**Status of Deposit Possession**

Jurists of all schools are agreed that safekeeping of deposits is recommended, and that the depositary receives religious credit for his safekeeping efforts. Moreover, they all agreed that the possession of a deposit is a trust possession, and that the depositary only assume guaranty if the deposit is adversely affected due to his negligence or transgression. This ruling is based on the Hadith: “The non-transgressing depositary does not guarantee the deposit.” 86

**Termination of a Deposit**

1. Return of the deposit to the depositor, whether the latter requested it or not.
2. Death of the depositor or the depositary terminates the contract, since they are the only two parties to the contract.
3. If either depositor or depositary falls into a long-term coma or becomes insane for an extended period of time, he would lose his eligibility to continue the contract.
4. If legal restrictions (hajr) are imposed on the depositors (due to mental incompetence) or on the depositary (due to bankruptcy).
5. If the depositor transfers ownership of the deposit to another (through a sale or gift, etc.) the deposit contract is terminated.

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86 Narrated by Al-Daraqutni and Al-Bayhaqi in their Sunan on the authority of Am rib Shuayb, his father, and his grandfather.
3.9.5 The Agency Contract

The term Wakalah literally means "preservation" in as the delegation of one person (the principal) for another (the agent) to take his place in a known and permissible dealing. On the other hand, the following more restrictive definition for Wakalah: it is the delegation of one living person to another of the performance of an act that permits delegation, and that the first person is permitted to perform himself.

Cornerstones

The jurists enumerate four cornerstones: (i) principal (ii) agent, (iii) object of the agency contract, and (iv) contract language.

Restricted Agency

The Hanafis and Hanbalis permitted unrestricted agency contracts, as well as agency contracts that are restricted by some condition. For instance, they allow a principal to stipulate that a second becomes his agent in selling a particular item if a named customer were to arrive. In this case, the agent is not permitted to deal in owner's property unless the condition is satisfied.

Temporary Agency

Jurist agreed that the agency contract may specify a termination date. This follows from the fact that agency is permitted to meet specific needs, and such need may be temporary.

Compensated Agency

The agency contract can be valid with or without the agent being paid a wage. This follows from the fact that the Prophet's (PBUH) paid his agents for the collection of charities.

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88 Al-khatibAlshirbani (Shafiis) No.81, vol2, p.217.
89 Al-kasani (Hanafi), vol.6, p.20.
Comprehensive Agency

The Hanafis and Ma'likis permitted comprehensive agency, or “power of attorney”, whereby the agent is permitted to take all legal actions of the principal that may be delegated to another.90

Legality

Quran: For instance, an example of agency in purchasing foodstuffs is found in (18:19): “Now send one of you with this money to the town; let him find out which is the best food and bring some to you”.

Hadith: that establishes the permissibility of agency. One such Hadith was narrated in Al-Bukhari and Muslim that the Prophet (PBUH) sent agents to collect the zakah (alms tax). Another narration also establishes that He (PBUH) commissioned Hakim ibn Huzam as his agent to buy an animal for ritual sacrifice, and his commissioning of Urwah Al-Bariqi to buy a sheep.91

The Muslim nations have established a consensus on the permissibility of agency contracts, since individuals often cannot administer all of their affairs, and thus have a need to commission agents.92

3.9.6 The Assignment of Debt Contracts

The word Hawalah is derived from Tahwil, which conveys the meaning of shifting a thing from one place to another. In the language of law it means “the shifting or assignment of debt from the liability of the original debtor to the liability of another person”93 the purpose of Hawalah is the payment of debt through the assignment of a claim. The debtor

90 IbnAbidin (Hanafi), No.85, vol.7, p.357.
91 Shawkani, No.79, vol.5, p.270.
92 IbnQudamah, No.73, vol.5, p.79.
93 Zayla I, Tahyin al-Haqiq vol.4, p.1717.
who transfers debt is called Muhil (debtor-assignor), the creditor Muhal (creditor-assignee) and new debtor to whom transfer is made, Muhalalayh (transferee).

Validity of Hawalah

It is narrated by Abu Hurayrah (RA) that the Holy Prophet (PBUH) said: “To evade and defer (payment of loan) on the part of a person who is rich, is tyranny. If loan is transferred to a rich person he (the transferee of liability) should be pursued (for its payment).”

It is narrated by Ibn Umar (RA):

“To evade and defer (payment of loan) on the part of rich person is cruelty. And if it (liability) is transferred to a rich person, he should be followed.”

Kind of Hawalah

Hawalah is either absolute (Mutlaq) or conditional (Muqayyad). Absolute Hawalah refers to that contract where payment is not restricted to the property of the transferor in the hands of transferee. Hawalah is conditional when it contains a stipulation that the creditor’s debt may be paid from the debt of the debtor due from the transferee or anything belonging to the debtor, which in possession as a security with the transferee.

The effect of the two categories determines the validity of other classification i.e. Hawalah al-haq and Hawalah al-dyn because Hawalah al-haq is a form of Hawalat mutlaq. It is to be noted that in Hawalat al-haq, the right of creditor in the debt due from the debtor is transferred to a new party. It is against Hawalat al-dayn in which the liability is transferred to a new party.

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94 San’ani, Muhammad ibn Isma’il, No. 78, vol. 6, p. 17.
95 Shawkani, No.79, vol.5, p.250.
Condition

- Hawalah means shifting or assignment of debt from the liability of original debtor to the liability of another person.
- After the transfer of debt, the original debtor is discharged from his liability.
- In absolute Hawalah, the transferee after making payment to the creditor can claim its reimbursement from the debtor. In restricted Hawalah the right of debtor to property with the transferee, ceases.
- Hawalah resembles negotiable Instruments in that its purpose is to guarantee the payment of debt to the creditor. An instrument is also negotiated for the purpose of guaranteeing or securing the payment of loan due on a bill of exchange.

3.9.7 The Guarantee or Surety Ship Contract

Literally the word Kafalah means joining and merging. Technically it is defined as merging of one liability with another in respect of demand for performance of an obligation. It is defined as a contract which combines one’s zimmah (liability) with another person’s zimmah. It is contractual guarantee given by the guarantor to assume the responsibilities and obligations of the party being guaranteed on any claims arising thereof. This principle is also applied in loan guarantees whereby, the guarantor assumes the liability of the debtor when the debtor fails to discharge his obligation. This is also known as Dhaman.

Elements of Kafalah

According to majority of viewpoint, contract of Kafalah has five elements:

(i) Kafil or damin (surety)

(ii) Makfulbihi or madmun (subject matter of Kafalah)

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(iii) Makfulanhu or madmunanhu (obligor)

(iv) Sighah, i.e., offer and acceptance (form of contract)

(v) Makfullahu (obliged or creditor)

Legitimacy of Kafalah

Quran: in surah Yusuf, the prophet Yusuf (AS) guaranteed to give a camel-load to the one who would restore the missing drinking cup of the king. The Quran says “He who restores it, shall have a camel-load, and I guarantee it.”

Sunnah: The Holy prophet (SAW) said “the guarantor is responsible”. And it is narrated in Sahih Bukhari that the Holy Prophet (SAW) once refused to lead the funeral prayer of a person because he had not paid his debts. On that Abu Qataadah, a companion of the Holy Prophet undertook to pay his debt, so the Prophet (SAW) accepted his guarantee and led the prayer.

Ijma: besides, there is a consensus of opinion among all Muslim jurists that Kafalah is a valid contract because it serves the need of the people. It secures the right of the creditor and repels harm from the debtor.

Kind of Guarantee or Surety Ship

1. Kafalah bi al-nafs, i.e., surety ship for the person.

2. Kafalah bi al-mal, i.e., surety ship for the property or the surety for the discharges of claim.

Kafalah bi al-Nafs:

This is a contract whereby the surety undertakes to produce the person. This is generally required when a person becomes surety to produce an accused person before the court of law.

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99 Qur'an 12:72.
100 Shawkani, No. 79, vol. 5, p. 251.
Kafalah bi al-Mal:
It is the surety for the satisfaction of claim whereby the insurer may be called upon to perform the obligation of the principal debtor if he makes default in the payment of his debt. Kafalah bi al-Mal is further divided into following kinds:

I. **Kafalah bi al-Dayn (Surety for Debt):** it means to guarantee the payment of debt to the creditor owed by the principal debtor.

II. **Kafalah bi al-Taslim (Surety for Possession):** it is surety to delivery of property to its owner such as to be surety on behalf of a lessee to transfer possession of leased property to the lessor or his agent on expiry of the lease period.

III. **Kafalah bi al-Dark:** is a guarantee by a seller that he will return the price of object if it is taken over by somebody else in exercise of his better right. It is also defined as a "guarantee in favour of seller that if the title of the seller is defective, the surety will make good the loss suffered by the purchaser on that account".101

3.9.7 Contract of Pledge

**Definition**

Rahn (Pledge) is the security that can be lawfully employed of satisfaction of a claim in respect of a debt.102 In other words "Rahn" means to pledge or lodged a real or corporeal property of material value in accordance with the law, as security for a debt of pecuniary obligation”.103

**Legitimacy**

Quran: "If you are on journey and cannot find a person to write (your debt), the pledge in hand (shall suffice)".104

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102 Majallah, Art. 701.
103 E.W. Lane, Arabic English Lexicon, letter, S.V. "R"
104 Qur'an 2:282.
**Sunah:** Hadrat Qatadah narrated that Anas (RA.) went to the Prophet (SAW) with barley bread with some dissolved fat on it and He (the Prophet saw) had mortgaged his armor to a Jew in Madinah and took from him barley for his family’.

Hadrat Aisha narrated that the Prophet (SAW) bought some foodstuff on credit from a Jew for a limited period and mortgaged him armour for it.\(^{105}\)

**Legal Status of the Pledged Property**

The pledge property assumes the status of trust in the hands of pledgee. Thus, if it is destroyed or lost without negligence fault or wrongful action on his part he will not be held liable. He will remain entitled to his debt due on the pledger.

**Legal Consequence of Pledge**

1. The pledge has a right to keep possession until redemption of the pledge.
2. The pledgee can sell the pledged property with the permission of pledger, when the debt becomes due in order to satisfy it out of the proceeds.
3. The pledger cannot sell pledge without consent of pledge.
4. It is permissible for the pledger to appoint the pledge his attorney to sell property when the time of payment approaches.
5. The pledgee is not allowed to let out or give the pledge in loan because he is himself prohibited benefiting from it.
6. If after the discharges of the debt the pledge perishes in the hands of pledgee.\(^{106}\)

**3.9.8 The Gift Contract**

Jurists define the gift contract as: “A voluntary contract that results in uncompensated ownership transfer between living individual”.\(^{107}\) On other hand “It is a contract initiated by

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\(^{105}\) Bukhari, Sahih, vol.3, p.54.
\(^{106}\) Muhammad Tahir Mansuri, No.43, pp.321-322.
an eligible party to transfer ownership of existent and deliverable properties to another without compensation”

There are Quranic verses that permit and recommend gift-giving. “But if they, of their own good pleasure, remit any part of it to you, take it and enjoy it with right good cheer” (4:4)

In one Hadith, the Prophet (SAW) is narrated to have said: “Exchange gifts so that you may love one another”.108 The Prophet (SAW) was also narrated to have said: “Do not underestimate the significance of neighbor’s gift to her neighbor, even if it is only a sheep’s foot”109

Cornerstones and Condition

The Jurists enumerate four cornerstones for the gift contract: donor, done, object, and contract language.110

- The donor is the owner of the object of gift, provided that he is eligible to give a gift.
- The done maybe any human being. Thus, Jurists agree that it is permissible for someone to give all of his property to a stranger (someone who is not a family member).
- Any owned property is eligible for being the object of a gift
- The gift contract language may consist of any words or actions that indicate offer and acceptance.

Legal Status of Gifts

The Hanafi’s render the legal status of the gift contract non-binding, while the other jurists consider, it is binding except for a father giving a gift to a child. In the latter case, the

107 Al-khatib Alshirbani (Shafiis), No.81, vol2, p.396.
110 Ibnuluzayy (Maliki), Al-QawaninAlFiqhiyyah, Fas: Matba at Al-Nahdah, p.366.
Malikis permit rescinding the gift before receipt only, while the Shafi'is and Hanabili's permit rescinding it before or after receipt. The Shafi'is also extended this exception to grandfather, great grandfather, etc.}

3.10 Islamic Financial Transactions in Islamic Banking

3.10.1 Wadiah (Safekeeping)

Wadiah means custody or safekeeping. In wadiah arrangement, Customer will deposit cash or other asset in a bank for safekeeping; it can be divided into Wadiah Yad Amanah (Safekeeping or Trustee) and Wadiah Yad Damanah (Saving with Guarantee).}

3.10.2 Wadiah Yad Amanah (Safekeeping or Trustee)

The basic concept of wadiah yad al-amanah is that the trustee will only be responsible for damages to the assets or property entrusted in case of negligence and the trustee cannot mix the assets or property with his or other people's properties.

From viewpoint of Islamic banking, the saving account facility is offered to account holders who seek safe custody of their funds and wish to save money whilst current account facility entitles the depositor to receive his funds on demand and depositors may pay a fee to bank for safekeeping and service. There is not much difference between current deposits and saving deposits. Both deposits shall not be entitled for a return and no restriction on deposit or withdrawal are imposed. In this situation, the original position of the bank as the keeper of client's money under concept of wadiah yad amanah has changed status to wadiah yad damanah (guaranteed safe-custody).

3.10.3 Wadiah Yad Damanah (Guaranteed Safe-Custody).

The wadiah yad damanah is a combination of wadiah with daman (guarantee contract) principle. Under this rule, the bank can use the funds or deposits as it wishes and be

\[\text{Wahbah Al-Zuhayli, No. 33, p. 551.}\]

liable to refund back when demanded by clients. Any profit generated will be solely for the bank. However, the bank may grant *Hibah* (gifts) to the clients if the bank wants to share it but it is not an obligation.\textsuperscript{113} It can be divided into:

1. Saving deposit and
2. Current deposit

**Saving Deposit** (*wadiah yad damanhan*): The bank provides the customer with a passbook. The bank requests the customer’s permission to make use of the funds as long as the funds are with the bank. All profits generated from the use of the funds belong to the bank. However, the bank may, at its absolute discretion reward the customer by returning a portion of the profits generated from the use of his fund.

**Current Deposit** (*wadiah yad damanah*): Similar to savings deposit, the bank provides its customers with cheque books as in conventional banking. The bank requests the customer’s permission to make use of the funds as long as these funds remain with the bank. All profits generated are shared with the depositors.

3.10.4 *Musharakah* (Partnership)

*Musharakah* is another central pillar of the Islamic Bank model. The term is derived from the Arabic word *Sharikah*, which means “sharing” or “partnership”. Under such arrangement, two or more persons contribute their funds and managerial skills to undertake a business enterprise on the basis of mutual risk-sharing. *Musharakah* partners are free to agree on any ratio for profit sharing but they are required to share business losses in strict proportion to their capital contribution. In Islamic history, *Musharakah* remains one of the major modes for investment in business and trade.\textsuperscript{114}

One way of profitably using capital is for the bank to become a partner in business with the entrepreneur. Both entrepreneur and bank share in the investment and run the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{113} *Wadiahyad amanah* and *Wadiahyad damanah*, \url{http://arzim.blogspot.in/2010/02/application-of-wadiah-and-gardh.html}, (10 Sep 2012)
\item \textsuperscript{114} M. Mansoor Khan and M. Ishaq Bhatti, No.26, p.48.
\end{itemize}
\end{footnotesize}
business. The paid representatives and experts of the bank work alongside the entrepreneur. A partnership deed would specify the nature of business, the limits within which it is to be conducted, length of the term of arrangement, and the proportion in which profits are to be distributed. The loss, however, must be borne proportionately to the investment of capital. At the completion of business or at the expiry of the fixed term or at the time of winding up business, the profit or loss will be determined after completing the records of business and then shared out according to the above-mentioned principle. The net capital will be returned to the partners along with profit after deducting any loss.145

3.10.5 Mudharabah (Profit Sharing)

Mudharabah is a contract between two parties, i.e. the owner of the capital and the entrepreneur. The depositor, who is the owner of the capital, places a specified sum of money with the Bank (who acts as the entrepreneur) for the purpose of participating in the profits made from the utilization of the fund.

**Conditions of Mudharabah Contracts**

For investment account, the account normally operates under the contract of Mudharabah (Trustee Profit Sharing). The Bank accepts deposits from its customers who look for investment opportunities. The Bank acts as the entrepreneur. Both parties agree with the profit distribution / sharing ratio. The customer does not participate in the management of the funds. In the event of a loss, the customer bears all the losses. Profits generated from the use of the customer’s funds will be distributed according to the predetermined ratio. Only the distribution ratio is predetermined and not the actual amount of return. The return will only be known upon maturity or withdrawal of the investment. Profit must be distributed according to the agreed ratio and not less. If the Mudharabah venture results in a loss, the

owner of capital bears the loss entirely, i.e. the amount invested / principal amount. On the other hand, the entrepreneur does not get anything from the venture.

**Options Available upon Maturity**

Upon maturity the customer may:
1. Either come personally to the bank
2. Write a letter of instruction
3. Send a person bearing a letter of authority to renew or withdraw the deposits.

The customer is given options to:
1. Renew the principal and profit
2. Renew principal and withdraw the profit
3. Withdraw the principal and the profit

**3.10.6 Murabahah (Mark up Financing)**

Murabahah is a sale of goods at a price covering the purchase price plus profit margin agreed upon between the contracting parties. In Murabahah, the seller discloses the cost of the sold commodity. He tells the purchaser that he purchased commodity, say, hundred dollars and that he will charge ten dollars as profit over and above the original price. It is also permissible to fix the profit in percentage i.e. 5% 10% of the cost.

The payment in the case of Murabahah may be at spot, and may be on a subsequent date agreed upon by the parties. Therefore, Murabahah does not necessarily imply the concept of deferred payment (Bai Bithaman Ajil), as generally believed by some people who are not acquainted with the Islamic jurisprudence and who have heard about Murabahah only in relation with the banking transactions. The only feature of Murabahah is that the seller in Murabahah expressly tells the purchaser how much cost he has incurred and how

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117 Muhammad Tahir Mansuri, No.43, pp.211-212.
much profit he is going to charges in addition to the cost. If a person sells a commodity for a lump sum price without any reference to the cost, this is called “Musawamah”.

The Murabahah as the financial operation of Islamic Banking works in this way, the client approaches the Islamic Bank to finance the purchase of a specified commodity. The bank, either itself or through an agent (who could be the client himself) collects all the required information of the commodity, its price, names of dealers, etc. The bank informs the client of these details as well as of the margin which it would like to charges on the original price. The bank will purchase the specified commodity from a seller of its choice, paying the price of the commodity in cash, if a sale deed is required (e.g., in the case of a car or a house). Once the ownership of the commodity is transferred to the bank, it sells the commodity to the client on a deferred payment basis against an agreed price. The new price at which the bank sells the commodity to the client is the original price (which is the cost to the bank) plus the mark-up the bank is charging (which is its profit margin).

3.10.7 Bai Bithaman Ajil (Deferred Payment)

In the classical fiqh literature bay’al-mu’ajjal refers to a sale against deferred payment (either in lump sum or installments). Bay’al-mu’ajjal need not have any reference to the profit margin that the supplier may earn. Its essential element which distinguishes it from a normal sale is the deferred payment. Very rarely is Murabahah used by Islamic banks with the price paid immediately by the customer. When a customer approaches an Islamic Bank to finance a purchase through Murabahah the payment of the price is usually deferred, and most commonly paid in installments.

The due time of payment can be fixed either with reference to a particular date, or by specifying a period, like three months, but it cannot be fixed with reference to a future event.

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120 Muhammad Taei Usmani, No.75, pp.95-96.
122 Muhammad Umer Chapra, No.28, p.169.
123 Mahmoud Amin El-Gamal, No.40, p.11.
the exact date of which is unknown or is uncertain. If the time of payment is unknown or uncertain, the sale is void. The deferred price may be more than the cash price, but it must be fixed at the time of sale. Once the price is fixed, it cannot be decreased in case of earlier payment, nor can it be increased in case of default. In order to pressurize the buyer to pay the installments promptly, the buyer may be asked to promise that in case of default, he will donate some specified amount for a charitable purpose. In this case the seller may receive such amount from the buyer, not to make it a part of his income, but to use it for a charitable purpose on behalf of the buyer.\textsuperscript{122}

3.10.8 Ijarah (Leasing)

Modern application of Ijarah: There are two main types of Ijarah (Leasing) practiced by the modern banks namely,

1. Finance lease and
2. Operating lease.

1. Finance Lease: A financial lease involves a non-cancellable agreement between the bank and its customer for purchase by the bank of a specific asset and its lease to the customer for a long or intermediate term. The bank would retain ownership of the asset but the customer would have the exclusive right to the use of the asset and payment of specified rentals. At the end of the agreed period the asset reverts to the bank. The rentals would be sufficient to amortize not only the capital outlay but also to yield, after taking into account the 'salvage' value of the asset, an adequate amount of profit for the bank. The lease agreement may however include a purchase option whereby the customer can purchase the asset from the bank at the termination of the lease.\textsuperscript{123}

\textsuperscript{122}Muhammad Taqi Usmani, No.75, p.102.
\textsuperscript{123}Muhammad Umer Chapra, No.28, p.167.
2. **Operating Lease**: This is "non-full payment" lease as rentals are insufficient to enable the lessor to recover fully the initial capital outlay. The residual value is recovered through disposal or re-leasing the equipment to other users. In this lease major consideration is given to the use of equipment. Unlike the finance lease system, the lessee can cancel the contract before it expires without paying any penalty. Under this arrangement the risk of damage and depreciation is borne by the lessor.  

**Ijarah in Islamic Banks**

*Ijarah walqitina* (Hire-purchase): It is a combination of leasing movable or immovable property with granting the lessee an option of eventually acquiring the object of the lease. The financial institution rents a moveable or immoveable property to one of its clients who pay an agreed sum in installments over an agreed period into a saving account held with the same institution. The lessor who is usually the mudarib invests these installments in *Mudarabah* venture for the client's account. As, when the amount of deposits and accrued income on such deposits, equal the aggregate amount of the then outstanding lease payments, the lease is terminated and the lessee becomes the owner of the asset. Thus, *Ijarah waiqtina* is a lease agreement combined with an obligation to the lessee to purchase the asset during the lease or at the termination of the lease.

**Directing Leasing**

This is a mode where by the Islamic Banks allow the customer to use the capital assets owned by the banks for a limited period of time ranging from a few days to a few months depending upon the type of asset in question. In return the lessee pays a monthly or annual rental fee.

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124 Muhammad Tahir Mansuri, No.43, p.236.
126 Muhammad Tahir Mansuri, No.43, pp.236.-237.
3.10.9 Qard al Hasan (Interest Free Loan)

Since interest on all kind of loans is prohibited in Islam, a loan which is to be given in accordance with the Islamic principle has to be by definition, a benevolent loan (Qard Hasan), i.e. a loan without interest. It has to be granted on the grounds of compassion, i.e. to remove the financial distress caused by the absence of sufficient money in the face of dire need. Since banks are profit oriented organization, it would seem that there is not much scope for the application of this technique; However, Islamic Banks also play a socially useful role. Hence, they make provision to provide Qard Hasan besides engaging in income generating activities.127

Under the Qard-e-Hasanah system, the bank grants interest-free loans to destitute people on benevolent grounds. Under the service charge system, the bank plays an intermediary role as a non-profitable institution. The bank recovers only service charges from all types of borrowers to meet its operating costs. As a result, the bank pays no return to its shareholders and depositors.128

3.10.10 Salam (Forward Sale)

Salam is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. Here the price is cash, but the supply of the purchased goods is deferred. Salam was allowed by the Holy Prophet (SAW) subject to certain conditions. The basic purpose of this sale was to meet the needs of the small farmers who needed money to grow their crops and to feed their family up to the time of harvest. After the prohibition of Riba they could not take usurious loans. Therefore, it was allowed for them to sell the agricultural product in advance.129

127 Ausaf Ahmad, Contemporary Practice of Islamic Financing Techniques (Jeddah: IRTI, 1993), P.49.
128 M. Mansoor Khan and M. Ishaq Bhatti, No.26, p.145.
129 Muhammad Taqi Usmani, No.75, p.186.
Islamic Banks use Salam as a mode of financing. They finance the needs of farmers who need money to grow their corps. They enter into an agreement with them for advance purchase of agriculture produce, specifying complete details of the commodity, its quality, price and time delivery and make payment of the amount at the time of entering into the agreement. When the commodity is produced and supplied to the bank on the appointed date, they sell it at profit in the market. Another problem with the simplified structure is the price risk that the bank is now exposed to. It is quite possible that price of the commodity declines during that time period resulting in losses to the bank. This risk is mitigated in a parallel salam, as the bank need not participate in the market at all.

**Example of Parallel Salam:**

Client1 sells commodity X to Bank on forward basis and receives price P in time period 0. Bank sells commodity X to Client2 on forward basis and receives price S in time period 0. At time period t, Client1 delivers commodity X to Bank. At time period t, Bank delivers commodity X to Client2. The amount S-P constitutes profit for the bank. The period in the second contract may shorter while the price may fix a little higher than the price of first transaction. Thus they earn profit by the difference between two price.

**3.10.11 Bai-Istisna (Commission to Manufacture Sale)**

Istisna is the kind of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser. But it is necessary for the validity of Istisna that the price is fixed with the consent of the parties and that necessary specification of the commodity (intended to be manufactured) is fully settled between them.

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130 Muhammad Tahir Mansuri, No.43, p.205.
132 Muhammad Tahir Mansuri, No.43, p.206.
Differences between Istisna and Salam

Keeping in view this nature of Istisna there are several points of difference between Istisna and Salam which are summarized below:

I. The subject of Istisna is always a thing which needs manufacturing, while Salam can be effected on anything, no matter whether it needs manufacturing or not.

II. It is necessary for Salam that the full price is paid in advance, while it is not necessary in Istisna.

III. The contract of Salam, once effected, cannot be cancelled unilaterally, while the contract of Istisna can be cancelled before the manufacturer starts the work.

IV. The time of delivery is an essential part of the sale in Salam while it is not necessary in Istisna that the time of delivery is fixed.\(^{133}\)

Islamic Banks and Financial Institution use Istisna as a mode of financing. They finance the construction of houses factories on a piece of land belonging to client. The house or factory is constructed either by the financiers himself or by a construction company. In this later case, the bank enters a sub-contract with that construction company. But if the contract concluded between the bank, i.e., the financier, and the client provides specifically that the work will be carried out by the financier himself, then the sub-contract is not valid. In such a case, it is necessary that the bank should have its own construction company and expert contractors to discharge the task. The price of construction may be paid by the client at the time of delivery or any other time agreed upon between the parties. The payment may be in lump sum or in installments. In order to secure the payment of installments, the title deeds of the house or land may be kept by the bank as security till the last installment is paid by the client.\(^{134}\)

\(^{133}\) Muhammad Taqi Usmani, No.75, pp.195-196.

\(^{134}\) Muhammad Tahir Mansuri, No.43, p.211.
Parallel Istisna (Manufacturing) Contract

Like the parallel Salam a new contract; parallel manufacturing, has recently emerged into practice. Same conditions which are applicable to parallel Salam shall be applicable to this new contract as well.135

3.10.12 Bai Al I-nah (Same Item Same Repurchase)

*Bai-inah* refers to trading whereby the seller sells his assets to the buyer at an agreed selling price to be paid by the buyer at a later date. After that, the buyer immediately sells back the assets to the seller at a cash price, lower than the agreed selling price.

**Opinions of Earlier Islamic Jurists**

Earlier Islamic jurists had different views on determining the *hukm* on *bai-inah*. The following were their views:

The majority were of the opinion that *bai-inah* was not permissible because it was the zari’ah (way) or hilah (legal excuse) to legitimize riba(usury).

The Hanafi *Mazhab* was of the opinion that *bai-inah* was permissible only if it involves a third party, which acts as an intermediary between the seller (creditor) and buyer (debtor).

The Maliki and Hanbali *Mazhab*, on the other hand, rejected *bai-inah* and considered it invalid. Their opinion was based on the principle of saddzari’ah that aims to prevent practices that can lead to forbidden acts such as, in this case, Riba.

The Syafi’i and Zahiri *Mazhab* viewed *bai-inah* as permissible. A contract was valued by what is disclosed and one’s *niyyah* (intention) was up to Allah SWT to judge. They criticized the *hadith* used by the majority of the Islamic jurists as the basis for their argument, saying that it (the *hadith*) was weak and therefore could not be used as the basis for the *hukm*.136

135Maulana Ejaz Ahmad Samdani, No.41, p.57.
136Suruhanjaya Sekurity, No.4, pp.20-22.
The first and a very popular mechanism used by Islamic banks in South East Asian countries are based on repurchase or bai-al-einah. Islamic Banks in South East Asia have liberally used the mechanism of bai-al-einah for their financing activities. The mechanism allows banks to extend a loan similar to conventional loan without any kind of constraints.\footnote{Mohammed Obaidullah, No. 131, p. 105.}

3.10.13 Al Baidayn (Debt Sale)

The bai' dayn principle has always been a point of contention among past and present Islamic jurists. However, they differs opinion to allow debt sale or to prohibit it\footnote{Suruhanjaya Sekurity, No. 4, p. 17.}. It is important to clarify that there is difference between debt (Qard) and loan (Dayn) in Islamic jurisprudence. If someone, by the way of doing well with another, gives him a thing which is available in the market, this is call debt (Qard). For example Khalid requires one hundred dollars and Zaid provides him this money this is called Qard. If someone caused a loss to another or he owed to him some money by way of some transaction this is loan (Dayn). For example if someone purchased some item from the market and he did not pay the price of the thing-purchased, this price of the thing is called Dayn.

Various ways of selling the Dayn (loan) is of two kinds

1. Selling Dayn against Dayn.
2. Selling Dayn against cash.

**Selling Dayn Against Dayn:** these are of two kinds

a) **Transaction is made with debtor.** For example Zaid transacted Salam with Bakr for the purchase of 100 kg rice against 100 dollars after one month. After passing one month's period Bakr declined to provide rice. And said to Zaid that sell me this amount of rice for 120 and I shall pay you the money after three months.
b) Transaction is made with someone other than the debtor. For example, Zaid has to receive from Bakr 100 kg rice after one month. Zaid said to Khalid: I sell you the amount of rice, which I have to receive from Bakr next month and you pay me 120 after two months.

Selling Dayn again cash: There are of two kinds

a) Transaction is made with debtor. For example; Zaid illegally occupied the watch of Bakr. After one month he informed Bakr that I have your watch, and if you want your watch back you can purchase it against 100 dollars. Bakr agreed and paid the money.

b) Transaction is made with other than the debtor. For example; Zaid illegally occupied the watch of Bakr. Now Bakr says to Khalid: I sell you my watch which is in the possession of Zaid against 120 dollars.

New Forms of Sale of Dayn

There are some other forms of the sale of Dayn (debt), which have newly emerged and it can be explain as.

a) To sell the price: This may be explained in a form of example. Zaid deals in fertilizer. He sells one sack of it in cash in 100 dollars and charges 120 dollars on deferred payment. Zaid suggested him that he may sit in his shop. Whenever a customer comes up to purchase the fertilizer on deferred payment I shall give you a sack in 100 and you give it to the customer against 120 dollars.

b) Selling the prize or Salary due in future: This is also another form of selling of Dayn. That is to sell one’s salary or prize to another person before he gets it by a less price.
c) Sale of bill of exchange: When a businessman sells some goods, he prepares a bill in the name of the customer bearing some future date for payment. Now the customer (debtor) needs money and he brings the bill to a third person or to a bank. Bank purchases this document in a lesser amount written on the face of the document. When the date of payment arrives the bank pays the amount to seller and gets a profit. The process is called Discounting of the bill of exchange. Sometime bank also sells the document to another person against a little high rate. Thus the document is sold several times before its date of maturity.  

Opinions of Earlier Islamic Jurists

The Hanafi Mazhab looked at bai' dayn from the aspects of potential risks to the buyer, debtor, and the nature of the debt itself. They were unanimous in not permitting this instrument because the risks cannot be overcome in the context of debt selling. The debt is in the form of mal hukmi (intangible assets) and the debt buyer takes on a great risk because he cannot own the item bought and the seller cannot deliver the item sold.  

The Maliki Mazhab allowed debt selling to a third party subject to certain conditions to facilitate the use of this principle in the market. The conditions set by the Maliki Mazhab can be divided into three categories:

a) To protect the rights of the debt buyer.

b) To avoid debt selling before qabudh.

c) To avoid Riba.  

The Shafi'i Mazhab was of the opinion that selling the debt to a third party was allowed if the Dayn was mustaqir (guaranteed) and was sold in exchange for Ayn (goods).  

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139 Maulana Ejaz Ahmad Samadani, No. 41, pp. 22-24.
140 Al-Kasani, Badai’i’ al-Sana’i (Berita: Dar al-Fikr), vol. 5, p. 148.
that must be delivered immediately. When the debt was sold, it should be paid in cash or tangible assets as agreed.

Ibnu al-Qayyim was of the opinion that bai‘ dayn was permissible because there was no general nasor ijmak that prohibited it. What was stated was the prohibition of bai‘ kali‘ bi kali’.143

3.10.14 Al-kafalah (Guarantee)

It is a contractual guarantee given by the guarantor to assume the responsibilities and obligations of the party being guaranteed on any claims arising thereof. This principle is also applied in loan guarantees whereby the guarantor assumes the liability of the debtor when the debtor fails to discharge his obligation. This is also known as dhaman.144

Guarantee is covered under the term “Kafalah” in Islamic commercial law. There are two forms of guarantee: Kafalah, or surety and Rahnu, or pledge/mortgage. The two pre-Islamic contracts used for guarantee or safe return of loans to their owners were approved by the Holy Prophet (PBUH) and their elaborated applications were extended by later generations in order to avoid any iniquities to both parties in the contract of loan, especially to the creditor.

Legally, in Kafalah, a third party becomes surety for the payment of a debt unpaid by the person originally liable. The degree or scope of surety should be known and should not come with preconditions. It is a guarantee given to a creditor that the debtor will pay the debt, fine or any other liability. Rahnu, or pledge, is also a security for the recovery of debt if the debtor fails to repay it. Kafalah and Rahnu inter-relate in the case of debt, but they have different functions. In the contract of Kafalah, a third party becomes surety for the payment

142 Al-Syirazi, Al-Muhazzab (Beirut: Dar al-Fikr,), vol. 1, p. 262.
143 SuruhanjayaSekurity, No.4, p.18.
144 SuruhanjayaSekurity, No.4, p.39.
of debt, but in Rahnu, the debtor hands over something as a pledge to ensure the payment of

Letters of guarantee, Use of cheques (post-dated), Promissory notes, freezing cash

Third party guarantees, Hamish Jiddiyah (earnest money taken from a prospective

client to ensure the performance of any assignment or liability by him before execution of

Arbun (down payment taken as part of the settled payment taken after

execution of the formal contract).

3.10.15 Al-Rahnu (Mortgage or Pledge)

To ensure one's right is called Rahn (mortgage). There are different types of
guaranties used now-a-days by the banks to secure the recovery of their loans, and mortgage
is one of them. The distinctive of the contract of Rahn (mortgage) is that it has a
characteristic of a voluntary gift and resembles simultaneously to the contract of sale. As
there is no compensation in lieu of thing-mortgaged and the debtor can get his thing back as
soon as he pays the debt, it is just like a contract of gift and as the mortgagor is entitled, in
case the mortgagee does not turn up to pay the loan, to recover his loan by selling the thing-
mortgaged.

On this analogy, an Islamic Bank as a pledgee may derive benefit from a pledge in
return for its maintenance by it. A house, for instance, requires maintenance and the bank can
benefit by it on the above principle or charge the pledger a customary rate for its services or
even take it on lease and give it to someone for something more. The rental over and above
the customary rate of the bank's services should go to the pledger. Apart from pledge, an
Islamic bank has the right of lien i.e. the right to retain the property belonging to another
until a debt due from the later is paid. This is called a "possessory lien", which seems to be

145 Muhammad Ayub, No.9, p.169.
146 Maulana Ejaz Ahmad Samadani, No.41, p.78.
permissible under Islamic law on the analogy of a seller (in cash sales) who has been invested with a right to retain the property sold by him in his possession until its price is paid to him. Where only the interest in the property is transferred to the mortgagee and not its possession, has not been discussed in traditional books on Islamic law. However, contemporary scholars allow it on the basis of analogy.147

3.10.16 Al-Wakalah (Agency)

Wakalah is to substitute an agent for the principal to perform on behalf of that principal an act, which admits of representation. It creates a fiduciary relationship that exists between two persons, one of whom expressly or impliedly consents that another should act on his behalf. The one whose behalf the act is done is called the principal (asil) and the one who is to act is called agent (wakil).148

An agency contract may be specific or general. A bank, for example, may appoint an agent to purchase some kinds of goods as and when asked by it. This will be a general agency contract. If a bank asks an agent to sell his particular asset at a given price or as per its instruction, it will be a specific agency contract. Even in a general contract, the nature of job to be undertaken has to be clearly defined to avoid any disputes.

A Wakalah contract is used by Islamic financial institutions in respect of almost all modes like Murabaha, Salam, Istisna’a, Ijarah, Diminishing Musharakah and activities like L/C, payment and collection of bills, fund management and securitization. Wakalah may be both commutative and non-commutative. Islamic Banks mostly do not pay a fee to their clients who purchase/sell goods on their behalf or perform other functions. However, banks normally charge fees for agency services rendered by them on behalf of their clients.149

3.10.17 Al-Sarf (Currency of Exchange)

The Islamic law of contracts explicitly deals with exchange of currencies. There is a general consensus among Islamic jurists on the view that currencies of different countries

147 Muhammad Ayub, No.9, pp.171-172.
149 Muhammad Ayub, No.9, pp.348-349.
can be exchanged on a spot basis at a rate different from unity. There also seems to be a general agreement among a majority of scholars on the view that currency exchange on a forward basis is not permissible, that is, when the rights and obligations of both parties relate to a future date. However, there is considerable disagreement among jurists when the rights of either one of the parties, which is same as obligation of the counter party, is deferred to a future date.

The second possibility is that the transaction is partly settled from one end only. For example, A makes a payment of Rs1000 now to B in lieu of a promise by B to pay $50 to him after six months. Alternatively, A accepts $50 now from B and promises to pay Rs1000 to him after six months. There are diametrically opposite views on the permissibility of such contracts. The Fiqh Academies across the globe have been deliberating on the permissibility of such contracts. Such contracts are however, not very common in the conventional financial markets.

The third scenario is that settlement of the transaction from both ends is deferred to a future date; say after six months from now. This implies that both A and B would make and accept payment of Rs1000 or $50, as the case may be, after six months. Such contracts are known as currency forwards and futures in mainstream finance. The predominant view is that the contracts are not Islamic permissible.

Yet another form of contracting, which has been described as, an Islamic swap may be as follows. A makes a payment of Rs1000 to and receives US $50 from B today at the given rate 1:20. Both A and B use and invest the money so received at their own risk. At the end of a stipulated time period, say six months, the transaction is reversed. A repays US $50 to and receives Rs1000 from B. This form of contracting can also be viewed as an exchange of or swapping of interest-free loans between A and B. This is in contrast to conventional swaps, which are generally interest-based and involve swapping of principal (often notional)
and interest payments. Conventional swaps clearly have no place in the Islamic system. Islamic swaps may help both A and B in various ways, such as, enabling them to manage their currency risk. There are again divergent views on the permissibility of such contracting.

The other common form of currency-related contracting in mainstream finance relates to purchase and sale of currency options. Scholars who consider that currency exchange must be settled on a spot basis rule out the possibility of any option for either or both parties. The currency option if considered as a promise, is not binding as the two parties cannot agree in advance to the rate to be applied for currency exchange in future according to the traditional Islamic law.¹⁵⁰

3.10.18 Al-Ujr (Mode of Fee)

The modern commercial banking involves a wide array of services to the customers, many of which are fee-based. These are distinct from products and services that are fund-based. Since these do not require an employment of funds, but still contribute significantly to the bottom line, their importance can be hardly over emphasized. Fee-based products also involve a lesser degree of divergence between Islamic and conventional practices, while Islamic Banks are currently offering a wide range of such products and services such as Letter of Credit and Letter of Guarantee. Islamic banks, like their conventional counterparts, provide fee-based services, such as,

a) safe-keeping of negotiable instruments including shares and bonds and collection of payments (based on an agreement of *wakala* under which the Islamic bank acts as the *wakil* or agent of its client);

b) internal (domestic) and external transfer operations; (based on an agreement of *wakala* under which the Islamic bank acts as the *wakil* or agent of its client).

¹⁵⁰Mohammed Obaidullah, *Teaching Corporate Finance From an Islamic Perspective* (Jeddah: King Abdulaziz University, 2006), pp.58-59.
c) hiring strong boxes (coffers) (based on an agreement of *amana* or *ijara*:

d) administration of property, estates and wills etc. (based on an agreement of *wakala*
under which the Islamic bank acts as the *wakil* or agent of its client)

Of late Islamic Banks have started offering various services related to real estate, property and project management. These are fee (*ujr*)-based services that are offered to customers irrespective of whether they avail financing or not. These are natural extensions of an Islamic bank’s financing activities. Since the financing activities are concentrated in the property finance and/or project finance, the bank benefits from the synergy that such fee-based activities provide.\(^{151}\)

\(^{151}\) Mohammed Obaidullah, No.131, pp.113-116.